> plan. Without the proposed pricing flexibility for all LECs, the benefits of competition will not accrue to customers, and carrier access competition may raise industry costs and prices rather than lowering them.[2]

Based on our analysis, intervenors' recommendations to restrict LEC pricing flexibility ignore three applications of elementary economic analysis:

(i) Market power is a meaningful concept only in the context of an economic market, and such markets have both service and geographic components. Thus, it makes no sense to measure market power in the aggregate for all services and all geographic areas of all LECs.

(ii) Within an economic market, exercise of a firm's market power is constrained by the options that its customers have available, not by past choices that its customers may have actually made. Hence, pricing flexibility should be granted to LECs in markets where competitors have sufficient capacity within reach of a sufficient volume of customers so that the LEC would be unable to maintain price above the competitive level.

(iii) Where pricing limitations are warranted, price cap constraints should protect customers against prices that are too high, and price floors should protect competitors against anticompetitive pricing practices that lead to prices that are too low. Within these boundaries, price changes to respond to competition for individual services or customers are entirely pro-competitive and make all customers--those who receive discounts and those who do not--better off than if discounts were forbidden and the business lost to a rival.

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[2]Richard Schmalensee and William Taylor, "Comments on the USTA Pricing Flexibility Proposal," Attachment 4 to the Comments of the United States Telephone Association, CC Docket No. 94-1, May 9, 1994, at 44.

Requests to restrict LEC pricing flexibility that ignore these precepts are fundamentally anticompetitive in that they restrict the ability of formidable competitors in carrier access markets to lower prices and provide customized services to individual customers.

II. Economic Markets

Prices of dominant telecommunications firms are regulated primarily to prevent firms with market power from (i) charging prices that are too high and (ii) engaging in certain anticompetitive pricing practices--e.g., predatory pricing, cross-subsidization, and price squeezes--which result in prices that are too low. A prerequisite for either concern is the possession of market power: i.e., the ability to raise the price of the service above the level that would pertain under competitive circumstances.[3] By its definition, market power can only be assessed in the context of an economic market:[4] the ability of a multi-product firm to raise the price of shoes cannot affect its ability to raise the price of potato chips. Hence assertions such as

> "Viewing the market as a whole, the LECs not only have a market share of virtually 100 percent...The estimated annual telecommunications services revenues of the Tier 1 LECs are over $85 billion, while the annual revenues of the entire [CAP] industry in 1992 were less than $250 million, of which $175 million were derived from telecommunications services...Thus, the CAP industry's share of the local telecommunications market is approximately 0.2 percent" (MFS at pp. 39-40, partial footnote included).

or

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[3]As explained in our comments filed earlier in this proceeding, restraining the ability of the LECs to raise prices addresses both concerns. It ensures that inefficiently high prices are not charged by the LECs, and it also reduces the LECs' ability to employ anticompetitive below-cost pricing for some services while keeping the prices for other services artificially high to recoup their losses.

[4]The economic product and geographic market in which a service competes is the set of all competing services in all geographic areas which are sufficiently close substitutes for the service in question that they constrain the ability of the supplier of the service in question to raise price above the competitive level.

> "[LECs] today control 99% of the access market, and even more of the local exchange market" (Teleport at p. 20).

provide no information whatever concerning the LECs' ability to raise the price of any service in any market and thus have no relevance in assessing the desirability of LEC pricing flexibility for interstate access services. These comments ignore the specification of the appropriate economic product and geographic markets and confuse measures of market share with measures of market power.

A. The Product Market

An economic product market is a set of products or services which includes all close substitutes so that if a single firm controlled the sale of these services, it could profitably hold the price above the competitive market level. The Merger Guidelines define a product market as

> a product or group of products such that a hypothetical profit-maximizing firm that was the only present and future seller of those products likely would impose at least a small but significant and non-transitory increase in price.[5]

That is, a product market contains products that are close substitutes and excludes products that are not close substitutes. An alternative expression of this definition would be that the relevant product market was the smallest set of products that would be necessary to control in order for the firm to possess market power.

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[5]The threshold size and duration of the price increase generally considered by the Department when using the definition is a five to ten percent increase in price lasting for at least two years: see United States Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, April 2, 1992, Section 1.11. The Merger Guidelines provide a framework of analysis for use by the Justice Department in determining whether or not to oppose horizontal mergers in the full range of U.S. industries. While the mechanism for determining the scope of an economic market is correct and applicable to telecommunications markets, other aspects of the Guidelines--particularly their reliance on particular ranges of the Herfindahl-Hirschman index to determine when to oppose a merger--do not necessarily apply to different public policy decisions. In particular, they do not apply to decisions about pricing flexibility for an incumbent firm in a previously regulated industry.

The product market relevant to the question of pricing flexibility for LEC interstate access service prices is the market for LEC interstate access services. This seemingly self-evident statement is recognized by some non-LEC commentors:

> "[T]he Commission must also recognize...it is competition for interstate access services that should be the Commission's focus [in this proceeding]. Competition in other areas of telecommunications is irrelevant to the LEC price cap plan." (Office of the Consumers' Counsel, State of Ohio at p. 12).

Services that are not--at least--substitutes for interstate access services have no impact on a LEC's ability to raise interstate carrier access prices and thus possession of market power for those services should not affect the LEC's market power for the services in question.

Competitors, on the other hand, would define the product market to include all services the LEC might produce:

> "[T]he relevant market for assessing the degree of competition should be the total regulated market currently served by the LECs, which would include access services, local services, intraLATA toll, and associated (tied) services (such as directory assistance, directory publishing). Analysis of the characteristics of the total local market is necessary because the LECs utilize a single, integrated network to provide all of these services. This allows LECs to cross subsidize the prices of services facing competition with revenues from less competitive services..." (Teleport at pp. 22-23).

This claim is economic nonsense which makes a mockery of market definition. Possible market power in directory publishing has no connection with the LECs' ability to maintain interstate carrier access prices above competitive levels. If market power in other services could lead to profits which could somehow be profitably invested in the anticompetitive destruction of rivals, the cure for that problem is price floors for the competitive services, not indiscriminate regulation for all services, non-competitive and competitive alike. In fact, LEC profits gleaned from other services pose no more threat of anticompetitive behavior than funding from any other source of capital, e.g., (i) the profits AT&T earns in international services, (ii) the equity capital MCI receives from British Telecom, or (iii) the profits that Teleport's owners earn from the cable business. If any party

believes it profitable to subsidize competition in the carrier access market, there is no shortage of capital to undertake such investments.[6] For assessing market power for interstate carrier access services, all that matters is the substitutes available to customers for the LEC's interstate carrier access services.

Once in place, network capacity can be used to provide many different, functionally equivalent services. Hence the current use to which a competitor's capacity is put has little bearing on its possible future uses, so long as the cost of converting from the supply of one service to another is low. Product markets should thus be widely defined; the availability of fungible capacity from entrants means that a customer would have alternatives to a range of different LEC services. On the other hand, local service and carrier access service are not substitutes. If large business customers in a metropolitan area can send interstate toll traffic directly to an IXC using facilities from one or more CAPs, then the LEC's ability to raise prices in the carrier access market in that area is constrained despite the fact that it may be the only supplier of ubiquitous local exchange service.

B. The Geographic Market

The second fallacy in some competitors' comments is that market power or competition must be measured with respect to a single geographic market, comprising the service territory of the LEC:

> "Given the pervasive use of common facilities within LEC networks, the only meaningful way to analyze 'the current state of competition' is with respect

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[6]In particular, LECs have no ability to "cross subsidize the prices of services facing competition with revenues from less competitive services" because (i) the prices of competitive interstate carrier access services cannot be increased to offset decreases in "prices of services facing competition" because of the baskets, service categories and bands of the price cap plan, and (ii) local prices are regulated by the states and similarly cannot be increased to offset price decreases for competitive interstate carrier access services regulated by the FCC.

> to *all* services offered in a geographic area large enough to encompass the major part of shared and common facilities" (MFS at pp. 38-39, footnote omitted).

This fallacy is also implicit in the oft-repeated 99 percent revenue or usage measures of LEC market share which encompass all access minutes or revenues in all geographic areas.[7] Ignoring the geographic dimensions of the market is wrong because effective competition may exist in some geographic areas so that regulatory price flexibility will be necessary for efficient competition to occur and yet little competition may exist in other geographic areas. Of course, where customers have alternatives to a LEC service throughout the LEC's territory, the form of regulation should be changed for the territory in question.[8]

The Merger Guidelines defines the geographic market for a service as the area within which a single supplier of a service could profitably maintain price above the competitive level without encouraging customers to substitute towards services provided by firms in other areas. The fact that Pacific Bell might be (almost) the only supplier of carrier access service in Petaluma does not mean that it can raise prices for carrier access services in San Francisco. And, by definition, Pacific Bell's ability (or inability) to raise DS-1 prices in Petaluma has nothing whatever to do with the competitive alternatives facing customers in Boston. While one degree of price regulation may be appropriate in Petaluma, an entirely different degree of regulation might be required in Boston. As Teleport observes,

> "(t)he degree of competition varies from place to place...since the basic technology used by competitors -- fiber optic facilities -- is best suited to high

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[7]The 99 percent market share allegation, whether based on revenue or usage, is misleading and wrong. By assuming that the CAPs are the only alternative in the market, it disregards relevant sources of supply -- self-supply, end user purchases, and other telecommunications providers (e.g., cellular firms, cable companies and microwave providers).

[8]That is, the geographic product market is the smallest area outside of which services are poor substitutes for customers inside the area. This is not to say that a service cannot be deemed competitive in a wider geographic area than a geographic market. If, for example, customers throughout a LEC's territory have alternatives to LEC DS-1 or DS-3 services, then those services should be treated as competitive throughout the territory.

> volume, high density applications, not surprisingly competitive networks have tended to develop in areas with business and commercial properties" (Teleport at p. 27).

If the "degree of competition varies from place to place," then surely the appropriate degree of regulation must vary similarly.[9] In high density areas containing business and commercial properties, customers thus can choose their supplier of carrier access service long before residential customers in rural areas. If a LEC were required to supply carrier access services (i) at prices geographically averaged across both areas or (ii) under the same pricing rules in both areas, the LEC would soon become the uncontested supplier of rural carrier access service and would lose large amounts of urban carrier access business from which it could realize a contribution towards its common costs and for which it might well be the low-cost supplier.

C. Market Share and Market Power

The third principal fallacy in the intervenors' proposals is the use of current or historical market share as an indicator of current or future market power:

> "The CAPs' access revenues are less than 1% of the $26 billion in total LEC access revenues...Although definitions of a competitive marketplace vary, no economist would suggest that a one or two percent industry market share constitutes sufficient evidence of a competitive marketplace." (ALTs at pp. 3-4, 14).

Moreover, several intervenors propose market share standards as criteria for permitting the LECs to have pricing flexibility:

> "Chief among these metrics is the requirement that at least 30 percent of subscribers in an area are in fact using alternative providers for local exchange service" (AT&T at pp. 18-19); and

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[9]And if alternatives to a particular LEC service are available for customers throughout a LEC territory or RBOC region--i.e., across all geographic markets in the region--then pricing flexibility or relaxed regulation commensurate with the degree of competition is warranted throughout the region.

> "(T)he best way to identify 'competitive' markets...would be to measure both the percentage of customers who have competitive services available *and* the percentage actually subscribing to such services" (MFS at p. 45).

As we noted in our comments on the USTA access reform proposal, market power can be very different from market share, and for determining whether or not pricing flexibility is warranted, only the former is relevant.

When applied to measurements of its own market power, AT&T and its economists are careful to distinguish between measures of market share and market power:

> "the link between market concentration and market competitiveness is a tenuous one, and that measuring concentration is not a substitute for analyzing the factors that determine market performance....
>
> It is widely recognized that a firm's market power depends on whether rivals can supply defecting customers without significant increases in marginal cost and on whether consumers regard the products of other firms as good substitutes. In addition, it is widely recognized that there are many circumstances in which measures of market concentration based on the capacities of firms provide a better indication of market concentration than do measures based on their outputs. Where there is a large disparity between shares based on capacity and those based on output, as is the case in the interexchange market, it is especially important to take excess capacity into account in assessing market concentration and, in turn, market power."[10]

In AT&T's own words,

> "The presence of substantial excess capacity in the interexchange market effectively disposes of the assertions that AT&T has the ability to price its services anticompetitively. The various scenarios of anticompetitive conduct offered by some commentors--that AT&T could engage in predatory pricing, or tacitly collude with its competitors--all ignore the fact that AT&T's rivals have already invested in enormous reserves of sunk capacity that can readily be brought on line at relatively low cost."[11]

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[10]Statement of Stanley M. Besen, Appendix B to the Reply Comments of American Telephone and Telegraph Company, CC Docket 90-132, September 18, 1990, pp. 2-4, (footnotes omitted, emphasis in original).

[11]AT&T Reply Comments in CC Docket 90-132, op. cit., pp. 14-15.

Where LEC rivals have invested in sunk capacity, the same logic applies to carrier access markets.[12] It is irrelevant whether 30 percent, 60 percent, or no customers actually purchase service from an alternative provider; if alternative providers have capacity in place that can be brought on line at low additional cost so that the customer has a real choice of suppliers, the incumbent firm cannot exercise market power.

Under these conditions, market concentration is primarily an outcome of the competitive process, rather than a determinant of that process. Thus, measuring market share in isolation says nothing about the ability of a firm to raise price above the competitive level.

Moreover, criteria based on market share may provide powerful incentives for the regulated firm to behave inefficiently. If a regulated firm believes that restrictive regulatory policies will be dropped only if its market share falls, the firm will have an incentive to "sell market share" by raising price or lowering service quality to drive some customers away while increasing profits earned on those that remain. Handicapping the incumbent until the entrant achieves some preset market share would thus distort the competitive outcomes in the access markets: the LECs' incentives to explore, compete and invest in new access technologies would be disrupted, since they would derive competitive advantage at the margin by shedding customers. The mix of services provided in the near future by IXCs, LECs, CAPs, cable companies, cellular and PCS companies, the prices, and the service qualities could be very different if the LECs' were unable to respond to competitive offerings until a preset volume of business were lost.

Whatever the relevance of market concentration, the ubiquitous "99% market share" chant of intervenors is grossly mistaken on at least three counts. First, as we have discussed, 99 percent is not a market share because it does not measure the LEC's relative size in any product or

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[12]That is, if entrant capacity is available to customers, the incumbent cannot profitably raise its price. Moreover, if entrant capacity is sunk, then the incumbent cannot expect to dislodge the entrant--or at least its capacity--from the market by anticompetitive pricing tactics.

geographic market. Second, market analysis of carrier access services must account for the ability of IXCs to supply the service themselves rather than purchase it from a third party. AT&T is thus wrong when it asserts that

> "The only actual exchange competition faced by the LECs comes from CAPs -- and they account only for a tiny percentage of the access market, and do not compete at all in the local exchange calling business." (AT&T at p. 9).

Actual competition for carrier access services is faced every day by the LECs, and it comes as much from IXCs locating facilities and additional points-of-presence (POPs) to minimize their access costs as from CAPs providing interconnection between IXC customers and IXC POPs.

Third, as a measure of relative size, the 99% market share figures are based on current revenues or usage volumes, not capacity.[13] They thus fall into the logical fallacy of using measures of the past success of competitors in multiple markets as a test for the presence of constraints on LEC pricing in specific markets. Use of such measures prejudges the outcome of the competitive process by permitting the regulated firm to respond to competitive entry only after competitors have achieved some measure of success.[14] In San Francisco and Los Angeles, for example, Pacific Bell estimates that MFS and Teleport, the two largest CAPs in the nation,

> "have enough fiber installed in the...downtown areas to handle all of [Pacific's] transport traffic for these areas" (comments, page 78).

One of the important functions of competition among firms and technologies is to reveal which methods, firms and technologies are most efficient at producing particular services for specific customers. CAPs are hybrid firms, largely created by the inefficient pricing of LEC carrier access services and currently squeezed between the plans of long distance carriers to integrate forward into

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[13]The Merger Guidelines (cited in footnote 5), AT&T (cited in footnote 10), and our previous comments (pp. 10-11) all agree that share of capacity and not share of customers, revenues or service volumes is the relevant measure of the alternatives available to customers.

[14]When applied to its own case, AT&T vehemently disagrees with the notion that a high market share confers market power. See, e.g., AT&T Reply Comments in CC Docket 90-132, op. cit., pp. 8-14.

the local network[15] and the plans of the LECs to become full-service local exchange, long distance, video and data networks. It is thus by no means a foregone conclusion that CAPs will be able to serve a sufficiently large market to survive in their current form. As the IXCs' networks and those of the LECs evolve, incorporating possibilities of wireless communications, high bandwidth cable and optical fiber facilities for video and data, interLATA service for the LECs and more facilities-based intraLATA competition from the IXCs, determining which of these firms survive and supply which services to which customers is possibly the most important function of competition. That function cannot be served by regulation that presumes that particular companies, technologies or architectures should serve substantial portions of the market.

Teleport compares competition in local exchange service unfavorably with competition in interstate long distance service in 1982 and finds

> "(t)he basic assumption which underlies much of the Commission's Notice -- that the local telecommunications marketplace has changed so fundamentally that LEC price cap regulation must be revised -- is simply not true...local competition today is far weaker than long distance competition was in 1982, yet the FCC is examining ways to make competition easier for the LECs" (Teleport at 28).

On the contrary, regulation should be neutral among incumbents and entrants, and that neutrality is equally important if the incumbent has a 99 or 50 percent market share.

III. Criteria for Pricing Flexibility

In response to ¶ 95 of the NPRM, competitors and large customers have proposed measures to identify circumstances in which the LECs should receive reduced regulation or pricing flexibility. In general, these criteria are flawed because they fail to specify the appropriate economic

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[15]e.g., MCI's announcement of its multibillion dollar investment in extending its network into the local exchange.

market in which the measurements take place and because they base their measurements in part on the number or volume of customers that have switched to an alternative provider. Thus AT&T suggests that

> "(c)hief among these metrics is the requirement that at least 30 percent of subscribers in an area are in fact using alternative providers for local exchange service. Other measures of actual local exchange competition may also be appropriate. In all events, it is unnecessary to address this issue specifically at this juncture because there is -- by any measure -- no possibility of significant local competition in the next several years" (AT&T at pp. 18-19, footnote omitted).

As we have discussed, AT&T's criteria are not appropriate to determine when a LEC should receive pricing flexibility because market share, by itself, is the wrong measure and only interstate carrier access markets are relevant here.[16] In particular, the fact that CAPs supply 43 percent of the high capacity transport services in New York City[17] and that Bell Atlantic has lost more than 25 percent of the end user DS-1 traffic in its major markets of Washington, Philadelphia, Pittsburgh and Baltimore[18] means that "by any [market share] measure" the LECs cannot increase high capacity transport prices in New York and DS-1 prices in Washington D.C. above the competitive level. If the proper product and geographic markets are specified, there are large markets in which there is significant local competition today.

Similarly, MFS claims that there is no single, simple criterion for determining when enough competition exists in a particular market to eliminate a particular LEC's ability to exercise market power:

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[16]Note that the first sentence acknowledges that different geographic markets are relevant for applying the 30 percent test: "30 percent of subscribers in an area are...using alternative providers."

[17]See Quality Strategies, "High Capacity Services in the NYNEX Region - 1993," February 1994, at p. 4.

[18]Quality Strategies, "Bell Atlantic 1993 High Capacity Dedicated Access Market Share," at 12. Cited in Reply Comments of Bell Atlantic, In the Matter of Tariff Filing Requirements for Nondominant Common Carriers, CC Docket No. 93-36, April 19, 1993, at 2.

> "MFS believes that the best way to identify 'competitive' markets, after the removal of entry barriers, would be to measure both the percentage of customers who have competitive services available *and* the percentage actually subscribing to such services. When both of these measures pass certain predetermined thresholds (e.g., available to 50% of customers and actually used by 15% of customers), the Commission could presume that competition is firmly established in the market in question and that greater pricing flexibility for the LECs would then be justified." (MFS at p. 45).

Availability (and capacity) of alternative service providers is an important component of market power because it is the availability of alternatives that gives customers the ability to substitute away from the LEC's services if it prices them above the competitive level. Given the capacity of alternative service providers, the fraction of customers or volumes that are actually served by entrants is not useful for assessing market power. Such market share measures do not determine which carrier supplies which customers but rather are themselves determined as an outcome of the competitive process.[19]

MFS, like AT&T, focuses on the proportion of customers that have chosen an entrant rather than the proportion of capacity, usage or revenue. If the intent is to determine when sufficient substitutes exist that the LEC cannot profitably maintain a price above the competitive level, it should be obvious that the proportion of customers is irrelevant. The degree of substitution is gauged in proportion to the volume or capacity of customers, not their number. If many low-volume customers have no alternative to LEC switched access but customers controlling 90 percent of the usage volume do have alternatives, the LEC will find it unprofitable to try to raise price.[20]

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[19]CAPs or other providers are attracted to markets in which a substantial number of customers (and volume of business) can be accessed by a given facility. In many parts of the country, the interstate access markets have this characteristic. A facility accessing a single customer location can provide substantial volumes of business, and a facility that serves a single LEC wire center can also reach a large volume of business. According to Bell Atlantic, "76% of [its] interstate access revenues come from just 25% of its wire centers" (Affidavit of Richard E. Beville, page 2).

[20]In this regard, it is useful to recall that the three largest IXCs purchase roughly 90 percent of the LECs' carrier access traffic, and each of these customers determines at the margin where to purchase transport and where to embed transport in its own network.

Teleport apparently endorses use of the Merger Guidelines to determine when LEC interstate services should be accorded pricing flexibility:[21]

> "The Horizontal Merger Guidelines [including the Herfindahl-Hirschman Index] used by the Department of Justice and the Federal Trade Commission provide a useful analytical approach for determining if a group of LEC-provided interstate services should be allowed reduced or streamlined regulation." (Teleport at p. 17).

While the Merger Guidelines provide "a useful analytic approach" for specifying economic product and geographic markets and for quantifying market power, there is no reason to believe that levels of market concentration (as measured by the Herfindahl-Hirschman index) used to determine whether a merger should be investigated are also appropriate to determine whether a regulated firm should be permitted to respond to competition.

The market power analysis in the Merger Guidelines is designed to determine when mergers of two or more companies in concentrated industries are likely to lead to price increases. Thus "highly concentrated" markets--those having an HHI above 1800--might well be markets in which a merger could result in diminished competition or in tacit or explicit collusion leading to a market price increase, but that fact--by itself--does not suggest that regulated firms in such markets should be denied pricing flexibility. Markets in regulated industries are generally more concentrated than average because of historical restrictions on entry, and because of regulation, relative prices of services in such markets generally differ considerably from what they would be under effective competition and no regulation. Thus, the quantitative judgements that support the DOJ's decision

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[21]Presumably its advocacy of Merger Guidelines standards would commit Teleport to use economic product and geographic markets in its analysis, to use concentration of capacity rather than concentration of sales and to take into account the reactions of alternative suppliers to market price increases as discussed in the Merger Guidelines.

to oppose mergers in markets having an HHI above 1800 have little or nothing to do with the decision to permit pricing flexibility in concentrated regulated markets.[22]

IV. Pricing Controls to Protect Against Anticompetitive Behavior

Under price cap regulation for interstate carrier access services, the regulator must balance two concerns: (i) that the LEC will be able to exercise market power and raise prices above the competitive level in some markets and (ii) that the LEC will attempt to use market power to price carrier access services too low through predatory pricing, cross-subsidization or a price squeeze. Procedures that prevent the exercise of market power--that keep prices from rising above the competitive levels--are not likely to be the same as those that prevent anticompetitive pricing--that keep prices from falling below the competitive level.

A. Proposed Price Controls are Inefficient and Anticompetitive

Some LEC competitors propose specific pricing rules as safeguards to prevent anticompetitive pricing. Thus MFS asserts (p. 9) that

> "the LECs must be constrained from engaging in undue discrimination between those customers who may have effective competitive alternatives and those who do not, based solely on this factor...

and that while it does not oppose rate structures that "differentiate among customers based upon relevant cost-related factors," it asserts a danger that

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[22]Evidence that the market concentration standards differ for approving mergers and granting incumbent firms pricing flexibility can be inferred from an example suggested by Teleport: the interexchange long-distance market does not meet Teleport's proposed HHI standard for streamlined regulation and yet the FCC has applied several forms of streamlined regulation to the dominant firm in the interexchange market.

> "these types of rate structures can be abused, by creating price differentials that are excessive relative to the underlying cost differentials, to grant undue preferences to certain customers perceived by the LEC to be at "competitive risk," and thereby to impose excessive and unreasonable prices upon the remaining ratepayers."

Wiltel echoes the concern that price differentials would be excessive relative to the underlying cost differentials and would require

> "uniform overhead allocations across all price cap services...[and] allow[ing] LECs pricing flexibility but only if accompanied by indexing....(f)or example, if a LEC wants to introduce a term discount for dedicated transport at the DS3 level, it should also make the same percentage term discounts available for DS1 and tandem-switched transport." (pp. 31-32).

These proposals for LEC pricing restrictions are obviously self-serving and anticompetitive. Were they to be implemented, customers would be denied the very benefits that competition was instituted to deliver. Prices paid by individual customers in workably competitive markets depend on both cost and demand characteristics of the customer,[23] so that one cannot infer anticompetitive intent from price variation across customers that cannot be explained by cost variation.[24] Similarly, Wiltel's proposal of a constant markup of price above incremental cost and indexing of discounts would make it extremely costly for the LECs to respond to any competitive initiative by an entrant, since a price reduction for one service for one customer would have to be matched with price reductions for all services for all customers. In such a market, entrants would face little danger of price reductions initiated by the incumbent LEC, and the ability of competition to lower prices to consumers would be subverted.

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[23]In offering selective discounts, a firm is responding to market conditions. "Monopolists set price by reference to their costs...competitors set price by reference to the market," A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d at 1402.

[24]Indeed, LEC competitors routinely set their own prices in this manner, responding to market conditions with customer-specific services, prices, and volume and term discounts.

The Courts, the Commission, and economic science have all recognized that permitting a firm to reduce or restructure prices to retain customers or service volumes that it would otherwise lose to competitors would result in lower prices for all consumers, provided only that services were always priced above incremental cost. The reason is simple: at any price above incremental cost, every sale covers its own costs and provides some amount of contribution towards the fixed common costs of the firm. Other customers and other services do not bear "excessive and unreasonable prices" because of LEC volume or term discounts or customer-specific pricing; on the contrary, prices for other LEC services could be reduced if market-based pricing--above incremental cost--permits the LEC to retain business that it would otherwise lose to a competitor. As explained in an earlier case by AT&T:

> "In all events, the competitors' claim that single-customer offers are predatory is wrong, and the result they seek is antithetical to the Commission's procompetitive policies. The Supreme Court has held that lowering prices in response to a competitor's offer in order to retain or attract business "often is the very essence of competition," and benefits consumers so long as prices remain "above predatory levels." That is true whether the price cuts are general or limited to specific customers."[25]

Indeed, volume and term discounts and customer-specific prices and service configurations are normal and healthy consequences of competition in markets where customers have widely different needs for services. A benefit of CAP entry into carrier access markets has been that they generally provide such pricing options, as shown in this excerpt from Teleport's Tariff FCC No. 1:

> "The tariffed interstate common carriage rates contained in Section 5 are given in terms of maximum and minimum rates. The actual interstate common carriage rates applied at a given point in time will vary depending on the locality, company, term of the arrangement, date the arrangement was originally entered into, and volume characteristics. The Company may, from time to time, institute promotional arrangements which involve discounts on recurring charges or discounts or waivers of non-recurring charges.

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[25]AT&T Reply Comments CC Docket 90-132, op. cit., pp. 76-77 (footnotes omitted).

> Discounts based on volume, term, or promotional arrangements may, therefore, result in charges below the stated minimums in particular circumstances." (Section 4.1.1, p. 39, effective February 9, 1993).

Unfortunately, under the current price cap rules, LECs cannot provide such arrangements to their customers. This restriction denies customers the benefits of these types of competitive pricing and gives an unwarranted competitive advantage to LEC competitors in serving customers for which such arrangements are desirable.

A second concern is that adapting the rules governing pricing flexibility in the LEC price cap plan to the degree of competition in a market may be difficult. ICA asserts that

> "(t)he mechanics of altering baskets according to competition are extremely difficult to define in practice...The USTA proposal...allows LECs to designate individual exchange areas as initial, transitional or competitive market areas at any time. Multiple -- and in many cases, non-specific -- criteria could be used by the LEC to make this determination, under the USTA proposal. Much of the information that an LEC could rely upon to make this type of competitive showing may not be available to other parties or to the Commission from public, verifiable sources...The price cap plan should not be changed in a manner that requires a determination of the level or extent of competition for selected services..." (at 10).

MFS also

> "recognizes that a 'market share' test is subject to criticism on administrative grounds, since the Commission lacks the tools for precisely measuring service availability and market share in thousands of exchange markets throughout the country" (at 45).

First, as a factual matter, the criteria used to determine the classification of a market area in the USTA plan are very specific and do not rely on data inherently controlled by the LEC. To classify wire centers as TMAs, the LEC would have to show that a competitor were present or that expanded interconnection were available. The latter is a matter of record, and the former echoes the Commission's criteria for permitting zone density pricing.[26] To classify wire centers as CMAs, the

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[26]See the Special Access Order at ¶ 179, footnote 411.

LEC would have to show that a sufficiently large portion of customer demand had an alternative source of supply available and actively sought alternative sources of supply through RFPs or construction of their own facilities. Information regarding RFPs and customer construction permits are not uniquely available to the LEC. A showing of availability of alternative sources of supply requires knowledge of the locations of competitors' facilities and customer demand volumes.

While individual customer demand volumes are competitively sensitive, their current levels can be derived from billing information that is verifiable, auditable, and can be provided to the Commission. Of course, as competition grows in a wire center, the LEC will supply (and bill for) a decreasing portion of the total customer demand in the wire center, so that the proportion of the LEC's customer volumes accessible by competitors' networks will increasingly underestimate the proportion of volume in the wire center that has an alternative source of supply. Billing data from all suppliers, not just LECs, would be necessary to test the CMA criteria accurately, as proposed in the USTA Position Paper.[27] Practical alternatives to collecting data from all suppliers include (i) using contemporaneous LEC billing data, recognizing that the test would be conservative, (ii) using historical LEC billing data from a period prior to significant competitive losses in the wire center, (iii) using the conservative assumption that demand is distributed uniformly across the wire center, so that the CMA criterion is met if 25 percent of the land area of the wire center is accessible by a competitor, or (iv) using customer survey data to determine total and individual customer demand volumes in the wire center.

Second and more important however, there is no cost if wire centers are mis-classified as TMAs and little cost if they are mis-classified as CMAs. When wire centers are classified as TMAs, their prices and quantities are removed from the SBI and API calculations so that reducing

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[27]USTA Position Paper, "Competitive Market Area Demonstration and Data Reporting Requirements," filed as Attachment 9 to the Comments of the United States Telephone Association, CC Docket No. 94-1, May 9, 1994, Section VI.

prices to customers in TMAs cannot result in higher prices to customers who do not have competitive alternatives. Thus, if the wire centers were mis-classified, at worst, the LEC would have gained the flexibility to lower prices (above incremental cost) where such reductions were not required to meet competition. No customer would be made worse off, and because prices would remain above incremental cost, no competitor would have a legitimate complaint of anticompetitive behavior. The same logic would apply to wire centers classified as CMAs except that prices could rise in CMAs if there were not sufficient competition to prevent the exercise of market power. We showed in our previous comments that the proposed standard of substantiality of competition combined with the absence of barriers to entry or interconnection provided a conservative structural indicator of the absence of market power.[28] Moreover, the removal of CMA prices and quantities from the price cap calculations ensures that prices in other areas cannot rise to offset price reductions in CMAs.

Thus ICA's concern is unfounded. The criteria for pricing flexibility in the USTA proposal are explicit, verifiable, and not uniquely observable by the LEC, and the implementation cost of the plan should be easily outweighed by the gains from more vigorous price competition.

B. Predation Concerns are Unfounded

On p. 3, MFS asserts that

> "(b)ecause a very large proportion of LEC costs are attributable to shared and common facilities that produce both monopoly and transitionally competitive services, the LECs will have ample opportunities to shift costs among these services and engage in cross-subsidization and predation, unless constrained by effective and enforceable regulations."

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[28]R. Schmalensee and W. Taylor, op. cit., pp. 36-38.

As we outlined in our previous comments, the cure for predation concerns is price floors for competitive services, not cost accounting and mechanical constraints on pricing or supplying services in markets subject to competition.

Anticompetitive pricing tactics such as predatory pricing, cross-subsidization, and price squeezes all have two elements in common: they are strategies to discourage entry or induce the exit of competitors, and to be profitable, they require that an investment in foregone profits can be recouped through the acquisition and maintenance of market power.[29] The latter requirement is unlikely to hold in local telecommunications markets in which high capacity optical fiber networks can provide a wide range of different services and whose capital costs are largely sunk. Moreover, the types of pricing flexibility requested by the LECs--e.g., in the USTA pricing flexibility proposal--do not make predatory pricing behavior more likely. Flexibly-priced services are removed from the price cap under the USTA proposal so that the LEC cannot raise prices in one geographic area by more than would be allowed under ordinary price cap regulation in order to fund price reductions or below-cost pricing in a more competitive geographic area.

There are sufficient safeguards to address concerns regarding discrimination and anticompetitive pricing (predation, cross-subsidization, and price squeeze). Current regulatory constraints on local exchange carrier pricing prevent unwarranted price increases, decreases, and undue differences in prices across customers or interexchange carriers. Price cap regulation has been instrumental in limiting the ability and incentive for the local exchange carriers to engage in anticompetitive practices.

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[29]A firm that cross-subsidizes forgoes profit in the subsidized market by pricing below incremental cost. A firm undertaking a price squeeze forgoes the higher contribution it could earn from provision of the essential facility to a rival by selling at too low a price in the retail market.

V. Conclusions

In our previous comments in this Docket, we reviewed the USTA proposal to tie pricing flexibility within geographic markets to the availability of competing transport capacity to a sufficient proportion of customer demand in the market. Competitors and large customers propose instead that additional pricing flexibility be withheld until the LEC experiences significant losses of market share. However, the presence of substantial excess capacity in the market eliminates the ability of the LEC to price its services anticompetitively. The loss of any particular proportion of customer demand is irrelevant in assessing market power; if alternative providers have capacity in place so that customers have a choice of suppliers, the incumbent firm cannot exercise market power.

Proposals to restrict LEC pricing flexibility to limit their response to competitive entry are fundamentally anticompetitive. Carrier access rates, set artificially at fully distributed historical accounting costs, have no necessary relationship with the forward-looking incremental cost standard to which competition holds pricing decisions. Pricing flexibility is the mechanism by which the LEC price structure can adapt to competitive forces. Insulating competitors from efficient LEC prices would reduce the benefits that competition and expanded competition were intended to deliver. Without pricing flexibility, a procompetitive entry policy would merely redistribute the contribution currently embedded in the LECs' regulated prices differently across services and across entrants. LEC prices would not send efficient signals to competitors, and expanded entry would not result in an improved allocation of resources.

ATTACHMENT 4

Economic Performance of the LEC Price Cap Plan: Reply Comments

by

National Economic Research Associates, Inc.

ECONOMIC PERFORMANCE OF THE LEC PRICE CAP PLAN: REPLY COMMENTS

Prepared for
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